12.04 Troubled Debt Restructuring

When a debtor cannot pay a debt as it comes due, the debt is considered a *troubled debt.* (ASC 470) In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that *both* of the following exist:

1. The restructuring constitutes a *concession.*
2. The debtor is experiencing *financial difficulties.*

There are three ways to restructure the debt. Following are the descriptions and procedures from the perspective of the debtor. Note that all cases refer to a gain on restructuring. If the debtor transfers property that equals or exceeds the carrying value of the debt, it would be a repaid in full, which is not considered a troubled debt restructuring. Since the value will be lower than the carrying value, the debtor is relieved of a portion of the loan, which results in a gain.

- **Transfer of Property**
    - **Gain on restructuring** of payables is recognized for the difference between the carrying value of the liability and the fair value of the asset transferred.
    - **Gain/loss on transfer** of asset is recognized for the difference between the asset's carrying value and its fair value on the date of the restructuring.
- Equity Interest in Debtor
    - Debtor records **equity** as if it was issued for its **fair value** with increases to common stock and additional paid-in capital, as appropriate.
    - **Gain on restructuring** of payables is recognized for the difference between the carrying value of the debt and the fair value of the equity.
- Modification of Terms
    - Interest **rate** is **reduced**, reducing the payments and, in some cases, allowing the debtor to make payments as they fall due.
    - **Due date** of one or more payments is **delayed,** giving the debtor more time to obtain the resources necessary to repay the debt.
    - **Face amount, accrued interest**, or both are **reduced**, reducing payments and, in some cases, allowing the debtor to make the remaining payments.
    - When debt is restructured by modifying the terms of the debt:
    - If total future **payments** are **less than** the **carrying value** of the obligation, including accrued interest, the debtor will reduce the carrying value of the obligation to the total of the payments. This will result in a **gain** on restructuring of payables and all future payments will be treated as reductions of the principal, with no amounts recognized as interest expense.
    - If total future **payments** are **equal** to or **greater than** the **carrying value** of the debt, the effective interest **rate** will be **reduced** such that the present value of remaining payments will be equal to the carrying value of the debt. As payments are made, the effective interest method is applied, using the reduced effective interest rate. The **debt** is **not**

adjusted and payments in excess of the revised principal balance over the remaining term will be recognized as interest.

A. I have debt of 600; will give up an asset with a FMV of 500 and a BV of 300.
B. Give stock with a par value of 200 and a FMV of 300.
C. Modify the terms.

	Debtor	Creditor
CV Debt = 600		
	100 Gain on restructuring	(100) Loss on restructuring
FMV of asset giving = 500		
	200 Gain/Loss on disposal of asset	
BV of asset giving up = 300		

A. Transfer Asset

N/P	600		**Loss** - restructuring	100	
Asset		300	Asset	500	
Gain on restructuring		100	N/R		600
Gain on transfer		200			

B. Transfer Equity

N/P	600		Investment in stock	300	
Common Stock		200	**Loss** - restructuring	300	
APIC		100	N/R		600
Gain on restructuring		300			

C. Modify Terms

Assume the client has a $500 note payable outstanding, with interest payments of 10%, or $50, due at the end of each calendar year until the note matures. At 12/31/X1, the client is unable to make the required annual interest payment, and the creditor agrees to restructure the debt by forgiving the missed payment, reducing the principal on the note to $400, and requiring 10%, or $40, interest payments on 12/31/X2 and 12/31/X3, with the note principal due 12/31/X3.

On 12/31/X1, prior to restructuring, the client had a $500 note payable and $50 accrued interest payable, for a total liability of $550. The restructured loan will require two interest payments of $40 each and principal of $400, for a total of $480 in future payments. The difference of $550 - $480 = $70 is the gain on restructuring, recorded as follows:

12/31/X1		
Note payable	500	
Accrued interest payable	50	
Note payable		480
Gain on restructuring of payables		70

Notice that the new note doesn't distinguish principal and interest. This is because the client isn't even going to repay $550 owed before restructuring, so there really isn't any additional interest being paid. All future payments are applied to the note payable.

The accounting by the creditor is different. To be conservative, the payments under the new arrangement are discounted at a fair interest rate before comparing them with the liability.

Assuming the 10% rate in this example is fair, the new note has a present value of $400, and is recorded as such:

12/31/X1		
Note receivable	400	
Loss on restructuring of payables	150	
Note receivable		500
Accrued interest receivable		50

Normal interest income of $40 per year will be recognized over the next two years.

Fair Value Option

According to ASC 825, an entity has the option, but not the requirement, to report some or all of its financial instruments at fair value. Among those financial instruments that may be reported at fair value are recognized financial assets and financial liabilities.

A debtor may elect the fair value option for some of its liabilities without making the election for others, even if they are similar. When a debtor elects the fair value option for a liability, that liability will be reported at its fair value on any given balance sheet date. Any decrease or increase required to adjust the liability to its fair value is recognized as a gain or loss in the income statement in the period of change.

The election of the fair value option by a debtor does not affect the accounting by the creditor. The creditor has a similar option to recognize the receivables at fair value.

If the fair value option is not elected for liabilities, a debtor will account for them using traditional approaches covered in this section.

Bankruptcy ($16,750)

- Concerned with the distribution of assets in a liquidation.
  - **Secured Creditors** – perfected security interest
    - Fully secured – the value of the collateral covers the debt owed.
    - Partially secured – the value of the collateral is less than the debt owed. The remaining balance becomes an unsecured claim.
  - **Priority Claims** (paid one level at a time / **STOP-IT Drunk Driver**)
    - Support and alimony payments
    - Trustee, attorney and accountant fees
    - Owed to involuntary gap creditors
    - Payroll within 180 days up to $13,650
    - Individual consumer deposits up to $3,025
    - Tax claims within 3 years of the filing
    - **Drunk Driver** injury claims
  - **General (unsecured) creditors**